IN THE

Supreme Court of the United States

October Term, 1979

No. 79-643

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

RICHARD R. QUINLIVAN and ANN. M. QUINLIVAN, et al.,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION

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OPINIONS BELOW

The opinion of the Tax Court, supporting the position urged by the respondents herein, was filed on February 23, 1978. This opinion was not officially reported.[1] The opinion of the Eighth Circuit Court of Appeals, affirm-

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[1]The opinion of the Tax Court is reproduced in Appendix A to the Petition, referred to herein as "Pet. App. A."

ing the decision of the Tax Court is reported at 599 F.2d 269.[2]

JURISDICTION

The jurisdictional requisites are adequately set forth in the Petition.

QUESTION PRESENTED

Whether respondents are entitled to a deduction for their proportionate share of rental payments for office space made by a law firm of which they were members to an independent trustee of short-term trusts established by respondents for the benefit of their children, to which trusts respondents previously had transferred improved real property pursuant to Sections 671 through 678 of the Internal Revenue Code of 1954.

STATUTES INVOLVED

Section 162(a)(3) and Sections 671 through 678 of the Internal Revenue Code of 1954 (26 U.S.C.).[3]

STATEMENT

In general, respondents are satisfied with the statement of the facts of the case set forth in the Petition. However, respondents wish to draw the Court's attention to several facts not adequately emphasized in the petitioner's statement, all of which bear on petitioner's assertion that the gift and leaseback transaction involved herein were "prearranged."

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[2]The opinion of the court of appeals is reproduced in Appendix B to the Petition, referred to herein as "Pet. App. B."
[3]These statutes are reproduced in Appendix D to the Petition.

1. On January 2, 1964 respondents established short-term trusts for the benefit of their children under Sections 671 through 678 of the Internal Revenue Code of 1954, and that same day transferred property to the trusts. (Pet. App. A at 3a). These trusts were irrevocable for a term of ten years and six months. (Pet. App. A at 3a). The initial lease of the trust property was executed three weeks later, on January 21, 1964, for a term of three years. (Pet. App. A at 3a; Ex. 12-L). During the taxable years 1967, 1968 and 1969 at issue herein the lease of the trust property was renegotiated annually, in what the Tax Court concluded were "arm's-length" transactions. (Pet. App. A at 6a).

2. The lessees of the trust property during the taxable years 1967, 1968 and 1969 in issue were not the respondents, but a law firm composed of respondents and an independent third attorney, Gerald Williams. (Pet. App. B at 11a and note 3; Ex. 7-G). Although petitioner has drawn the inference that at the time the initial lease was executed in 1964 respondents were the only members of the law firm, this is merely an inference, and is not supportable by the record. Indeed, a more reasonable inference is that the failure of petitioner to introduce into evidence the law firm's tax return for 1964, which it easily could have done and which would show how many members the firm had in 1964, indicates that there were in fact members in addition to respondents at that time.

3. Under the terms of the trusts, the trustee had broad powers, including, in the words of the Tax Court, "the unfettered power to 'sell, lease, exchange or otherwise dis-

pose of the property' held in the trusts. . . ." (Pet. App. A at 6a).

REASONS FOR DENYING THE PETITION

The petition for a writ of certiorari should be denied for the following reasons:

1. THE COURT BELOW FULLY CONSIDERED THE ISSUES PRESENTED BY THE FACTS OF THIS CASE AND DECIDED THEM CORRECTLY.

The court below fully and correctly considered the issues raised by the facts of this case. Petitioner's criticism of the decision of the court below, which it characterizes as "fundamental error," is predicated, in part, upon its consistent failure throughout the course of this litigation to deal with these facts. Petitioner insists, contrary to the conclusion drawn by the Tax Court after it had heard all of the evidence in this case, that the gift and the leaseback were "prearranged."[4] Thus, petitioner argues, both the gift and the leaseback should be treated as a single, integrated transaction, and a deduction for rental payments made pursuant to the leaseback should be denied unless both the gift and the leaseback were motivated by a substantial business purpose.

Although the gift and leaseback may be "prearranged" in the petitioner's hypothetical "typical" case set out at pages 8 and 9 of the Petition, there is no evidence to support such an assertion here. Unlike the "typical" case, the leaseback in the instant case was not "simultaneous" with the transfer of property to the trusts, but occurred three

[4]The Tax Court concluded: "(n)or was the leaseback prearranged." (Pet. App. A at 6a).

weeks after that transfer.[5] Second, the period of the initial leaseback was not "for a total period . . . co-extensive with the term of the trust," as in the typical case, but for a period of three years, which period expired prior to the years here in question. (Pet. App. A at 3a). During taxable years 1967, 1968 and 1969 in question the lease was subject to annual renegotiation. (Pet. App. A at 3a, note 3). Third, unlike the "typical" case, the *grantors* did not lease the building back from the trusts; rather, a law firm, composed of the grantors and an independent third person, was the lessee.[6] In any case, there is no basis upon which to predicate a different result in this dispute depending upon who were the initial lessees of the trust property.

The petitioner's description of the "typical" transaction does not at all mention the significance of the degree of independence of the trustee from the domination and influence of the grantor, which is an obvious factor bearing on the likelihood of "prearrangement" between those parties. In the instant case the Tax Court found that the grantors were "not in any way connected with the trustee bank as shareholder, officer, depositor, or employee" during any of the years involved. (Pet. App. A, at 6a). Petitioner also neglects to mention that the trustee in the instant case had common law fiduciary obligations to the trust

[5]The trusts were established and the property was transferred to them on January 2, 1964. (Pet. App. A at 3a). The initial lease was executed on January 21, 1964. (Ex. 12-L).

[6]During the 1967, 1968 and 1969 taxable years in issue the law firm was composed of Richard and Roger Quinlivan, the respondents, and Gerald Williams. In 1967 and 1968 the law firm was a partnership. In 1969 it became a corporation. (Pet. App. B at 11a and n.3; Ex. 7-G).

beneficiaries to act reasonably and prudently in renting the trust property.

Petitioner's insistence on treating the gift and leaseback in the instant case as a single, integrated transaction also contravenes a recent decision of this Court regarding the applicability of integrated, or "step," transaction analysis in tax cases. *See Frank Lyon Co. v. United States,* 435 U.S. 561, 575-576 (1978), in which the Court emphasized the significance of the presence of a third, independent party in upholding the characterization of a sale and leaseback as two separate transactions, as opposed to the step transaction approach urged by the Government.

In light of the above, it is clear that the petitioner's assertion of "prearrangement," and its related integrated transaction analysis, are unsupportable as a matter of fact. Thus, the court below acted correctly in applying to the leaseback alone, as opposed to the gift and the leaseback, the tests set forth in Section 162(a)(3) of the Internal Revenue Code of 1954, as construed by the courts, in determining that the deduction for rental payments taken by respondents was allowable.

2. THE RELIEF SOUGHT BY PETITIONER MAY BE PROVIDED ONLY BY CONGRESS.

It is abundantly clear from the Petition that petitioner's concern in this case is not that the standards applied by the court below were incorrect, but that respondents, by virtue of their use of short-term trusts, were able to "shift" taxable income from themselves to their children. However, petitioner never has attacked the validity of the trusts established by respondents. Moreover, the use of short-

term trusts to allocate income from property to one's children or other beneficiaries has long been expressly sanctioned by Congress in Sections 671 through 678 of the Internal Revenue Code of 1954. As the Tax Court recently said, these provisions recognize "that valid trusts can be created which result in splitting family income and minimizing taxes if the grantor does not retain control of the property for his own benefit." *See Lerner v. Commissioner,* 71 T.C. 290, TAX CT. REP. (CCH) ¶35,544 at 3735 (1978).

Petitioner's argument, that both the gift and the leaseback must have a substantial business purpose in order for a taxpayer to obtain a deduction for rental payments on the leaseback, is an attempt to eviscerate the Congressionally sanctioned short-term trust. By its very nature, a gift is not made for a business purpose. The relief petitioner seeks herein amounts to a drastic amendment to the short-term trust provisions of the Internal Revenue Code, which can be effected only by the Congress.

3. THE ALLEGEDLY CONFLICTING DECISIONS RELIED UPON BY PETITIONER ARE DISTINGUISHABLE ON THEIR FACTS.

Petitioner also contends that this Court should grant a writ of certiorari because there is, it alleges, a conflict in the decisions of the federal courts of appeals regarding the circumstances in which rental payments by a grantor-lessee made subsequent to a gift and leaseback are deductible as an ordinary and necessary business expense under Section 162(a)(3) of the Internal Revenue Code of 1954. But, as the court below noted, "(i)t is not clear

that there exists a true split among the courts of appeals." (Pet. App. A at 17a, note 4).

In fact, the allegedly conflicting decisions cited by petitioner can be harmonized. Under Section 162(a)(3) of the Internal Revenue Code of 1954, a deduction for rental payments is allowed only if such payments are "necessary expenses . . . required to be made as a condition to the continued use or possession" of the rented property. In construing this language the courts have recognized that a principal element in determining whether the lessor-lessee relationship between the grantor and the trustee is substantial enough so that the rental payments are indeed necessary expenses required to be made as a condition to the continued use or possession of the property, is the degree of independence of the trustee from the influence and domination of the grantor. Where the trustee was independent from the control of the grantor, as in the instant case, the courts found that the rental relationship had adequate substance to allow the deduction. *See, e.g.: Brooke v. United States,* 468 F.2d 1155, 1157 (9th Cir. 1972) (recognizing that "(m)any decisions pivot on the issue of the independence of the trustee"); *Brown v. Commissioner,* 180 F.2d 926, 929 (3rd Cir. 1950), cert. denied, 340 U.S. 814 (1950) ("(w)hat is controlling is that there came into the picture a new independent owner, the trustee. . . .)" and *Skemp v. Commissioner,* 168 F.2d 598, 599 (7th Cir. 1948) (where the court noted that the taxpayer retained "no significant control over the trust").[7]

On the other hand, where the trustee was not indepen-

[7]*See also: Lerner v. Commissioner,* 71 T.C. 290, Tax Ct. Rep. (CCH) ¶35, 544 (1978), appeal pending, No. 79-4129 (2d Cir.); *Serbousek v. Commissioner,* T.C.M. (P-H) ¶77,105 at p. 77-488 (1977); and *Oakes v. Commissioner,* 44 T.C. 524, 529 (1965).

dent from the grantor the deduction for rental payments has been denied. *See, e.g.,* two of the decisions principally relied on by petitioner in its argument to establish that there is a conflict in the cases: *Perry v. United States,* 520 F.2d 234, 238 (4th Cir. 1975), cert. denied, 423 U.S. 1052 (1976) (stating that the trustee's independence was "largely illusory"); and *Van Zandt v. Commissioner,* 341 F.2d 440, 443 (5th Cir. 1965), cert. denied, 343 U.S. 928 (1965) ("it seems clear that we do not have the normal relationship that exists when an 'independent' trust is created. . . . Here, with respect to the only asset, the trustee had nothing whatever to do in the management of the trusts. . . .").[8]

The only decision relied on by the petitioner in which the significance of the independence of the trustee was denied is *Mathews v. Commissioner,* 520 F.2d 323, cert. denied, 424 U.S. 967 (1967). However, a factor in the *Mathews* case that significantly disturbed the court, the execution of the leaseback prior to the transfer to the trust, is not a factor in the instant case. Here, as has been noted already, the initial lease of the trust property was not executed until some three weeks after the transfer to the trust.[9]

[8]*See also: Audano v. United States,* 428 F.2d 251, 258 (5th Cir. 1970); *Furman v. Commissioner,* 45 T.C. 360, 364, aff'd, 381 F.2d 22 (5th Cir. 1967) (per curiam); and *Finley v. Commissioner,* 255 F.2d 128, 132 (10th Cir. 1958).

[9]The court below suggested that the real conflict in the cases, if indeed there is any, may be among the cases in the Fifth Circuit. (Pet. App. B at 17a). Even if respondents were to concede that *Van Zandt* and *Mathews,* both Fifth Circuit decisions, conflict with the decisions of the other circuits, it must be noted that in *Audano v. United States,* 428 F.2d 251 (5th Cir. 1970), decided after *Van Zandt* but before *Mathews,* the Fifth Circuit carefully considered the traditional tests used by the other circuits in resolving the issues presented by the case before it.

CONCLUSION

Respondents contend that, to the extent there is confusion in the cases, it is the direct result of the repeated efforts by the petitioner to obtain a judicially imposed amendment to Sections 671 through 678 of the Internal Revenue Code of 1954. Apparently, petitioner's goal is to make the short-term trust provisions of Section 673 unavailable whenever short-term trust property is leased to a party related to the grantor. In its pursuit of this goal and in order to support its step transaction analysis in this case petitioner has asserted, contrary to all of the facts of the case, that the leaseback involved herein was "prearranged."

The facts of this case are clear from the record. The pristine legal issue raised by these facts is whether the short-term trust provisions of the Internal Revenue Code should be unavailable where the grantor and the lessee of the trust property are related parties. The court below found petitioner's arguments to be so unpersuasive that it rejected them on three independent grounds. Yet, petitioner continues to contest this issue in a large number of cases.[10] Were it not for the considerable additional expense and delay that would result from a grant of a writ of certiorari in this case, respondents would not oppose petitioner's request for the writ, so that this Court could take the opportunity to put petitioner's arguments forever to rest. However, in light of the facts of this particular case, and for the reasons above stated, the petition for a writ of certiorari should be denied.

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[10]The Petition, at page 12, states that "there are currently 15 docketed cases pending in the Tax Court and 45 additional cases pending at various administrative levels in the Service. . . ."

Respectfully submitted,

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